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FACTORING AND LEASING, SOLUTIONS FOR CASH-FLOW'S PROBLEMS

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Abstract: Small and medium sized enterprises are a major part of the total companies in the EU, they represent about 99% of all business in EU. The COVID-19 affected all economies, all companies in all aspects, but one of the major problems of a business are the liquidities. The European Union established a set of directions and programs to help the private companies with solutions to increase the liquidities, but for those companies which are not eligible for those programs, factoring and leasing can be the remedy for the lack of cash, beside the traditional loan.

Keywords: financial leasing, operational leasing, factoring, cash-flow

1 INTRODUCTION

The present papers want to analyze by comparison two of the most recent forms of financing for SMEs, due to the fact that all companies were affected by the COVID-19 pandemic and the lack of liquidities is a major problem.

Traditionally, when the entrepreneurs start a company, they raise equity based on their own money, nonrefundable programs or from the 3 F (family, friends and fools), or some new solutions like crowdfunding or business accelerators. But after some time, when the company is set up, current activities are developing, the cash-flow can create problems who can lead to insolvency or even bankruptcy.

The aim of this paper is to present by comparison 3 sources of financing (loan, financial leasing, operational leasing and factoring) their advantages and disadvantages and to analyze the hypothetic case of an investment and the best financing solution.

2 LEASING

The term of leasing comes from the Anglo-Saxon word *to lease* with the simple meaning of renting. Economic, fiscal, accounting and structural changes lead to different forms of leasing, more appropriate for the necessity of the present market.

The Romanian market for leasing developed after the '90, but initially as a economical reality without any legal frame and only beginning with OG 51/1997 the leasing was defined and many fiscal and accounting were established and since than the legislation was modified according to international standards and practice.

One of the most important aspects that has been clarified by the legislation was the distinction between the two forms of leasing contracts: financial and operational leasing.

The Fiscal Code, OG 51/1997 regarding leasing operations and the most recent change in leasing legislation, Law 83/2021 which complete and modifies OG 51/1997 are the legal frame for the leasing In Romania. Our legislation is very recent comparing to other countries and for this reason was very connected from the beginning to IAS 17 Leasing and since 1st January to the IFRS 16 Leases who is replacing IAS 17.

2.1. Financial leasing

One of the biggest issues of leasing contracts was the delimitation between financial and operational leasing. According to IAS 17 and the Romanian Fiscal Code, a leasing operation can be considered financial lease if one of the following criteria are met:

- At the end of lease term, the lessee buys the asset which is the contract's object and becomes owner
- The lessee has the option to buy the asset and the price at the end of the contract is sufficiently lower than the fair value at the moment of the sale and this option is expected to be exercised
- The term of the contract covers most of the economical life of the asset (normed duration life) even if the contracts doesn't end with the acquisition of the asset (Romanian legislation require a minimum of 80% of the normal functional life of the asset
- The present value of the minimum payments made by the lessee compare to the fair value of the asset is lower

IFRS 16 LEASES replaces IAS 17 Leases and the most affected are the lessees because it changes the distinction between financial and operational leasing from the accounting view. According to the new regulations, from accounting perspective there will be no more operating leases contracts excepts those under 12 months (defined as short-term leases). So all leases contract will appear in the lessee's balance sheet, so we put an emphasis on the "right to use" the asset, so the principle substance over form is reflected here.

2.2. Operating leasing

The simplest definition for an operating leasing is that the leasing who doesn't meet the criteria for financial leasing is an operation leasing. The Romanian legislation consider a contract as operational leasing when all right and risks of the property right of the asset are transfer to the lessee, except the risk of the residual value (the bargain purchase option).

The accounting treatment for operating leasing requires that the payments to be treated as rent expenses.

Beginning with 2019, all contracts except those for 12 months or less to be treated by the lessee as financial contracts, meaning that the asset should be presented in the balance sheet and the related lease liability at the inception of the leasing contract. This regulation will change the operating leasing market, so in order to keep the former advantages of operating lease maybe long-term contracts will be transformed in short term contracts.

The operating leasing, as know before IFRS 16 provides several benefits for the lessee:

- All payments regarding leasing were treated as current costs and for companies who pay tax on profit (16%) this leads to 16% economy on those payments and this improves cash-flow
- Flexibility in using the most suitable equipment for their business
- No increase in long term debts

On the other hand, by the new IFRS 16, bringing the asset on the balance sheet and start on showing the depreciation and interest in costs make an impact on the financial indicators. There will be an increase in assets and liabilities, the operating expenses will decrease and the EBITDA will increase.

All operating leasing contracts will be analyzed and treated according to the new standard.

Table 1. The impact of IFRS 16 on the operating leasing contracts for the lessee

	IAS 17	IFRS 16
Assets	Off balance sheet	On the balance sheet
Liabilities	None	Financial liability
Depreciation cost	None	The amount of monthly payment split between depreciation and interest
Rent cost	The amount of monthly payment	
Interest cost	None	The amount of monthly payment split between depreciation and interest

2.3. Sale and lease-back

This type of leasing has been used on large scale because it presents advantages both for the seller lessee and for the buyer lessor. Sale and lease-back, usually know as simply lease-back is a selling transaction, immediately followed by a leasing contract.

The benefits for the seller/lessee are:

- Reduced risk of the transaction
- Transforming fixed assets immediately in liquidities, still preserving its production capacity
- The cost of sale and lease back are reduced compare to standard form of financing because parties can structure their terms of agreement
- Improvement of liquidity ratios
- Increase in solvency and financial health of the company
- Discretion of the transaction

The Romanian market for sale and lease back is not very developed despite its benefits. One of the possible explanations for this situation can be the lack of popularity for this type of leasing, or the fact that the lessor's offers are not very attractive or this product is not offered by all leasing companies.

3 FACTORING

3.1 Definition of factoring

Factoring is one of the most recent forms of financing for businesses and on the Romanian market we can speak about factoring only past 2003 but the evolution of this market shows the efficiency of this form of financing. The factoring is a simple solution to the complex problems that a business can face and is a form of short-term financing available to business that sells on credit.

The transaction is between a factor (bank, financial company) and the business that need money and doesn't want to wait for 2-6 months for its clients to pay so the adherent sells the invoices to the financial institution. Factoring differs from invoice financing and there are several forms of factoring.

From the point of view of the assumption of the risk credit there are two forms of factoring:

1. Recourse factoring – the factor lends the money using the accounts receivables as collateral and the company who receives the financing is ultimately liable for the invoices in case that their clients don't pay at the due term

2. Non-recourse factoring – the factor assumes the credit risk and he will take all measures in case that the invoices are not paid at due term to recuperate the amount. Of course, this risk is translated in higher cost of the factoring.

There are several advantages compare to other financing form, but I will only mention the most relevant from financial view:

- No liabilities shown in balance sheet
- No risks involved (non-recourse factoring)
- Reduced cost with account receivables
- Improvement of financial indicators (current liquidity)
- maintain

3.2 Factoring market

Despite the fact that each country has its characteristics, factoring is universally applied and one of the success key factors is the communication between the members of the factoring network, like FCI (Factors Chain International). Since 1968, when was founded until the end of 2021, the members grew up to almost 400. Recent studies shows that in EU, the growth rate of factoring is higher than the growth rate of the economies. As shown in the following chart, except 2020, the factoring transaction are on an ascendent path:

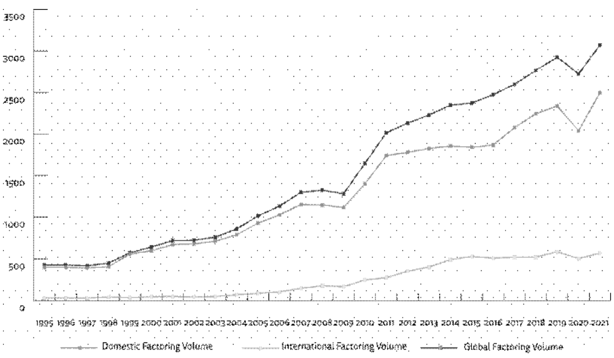

Figure 1. Evolution of factoring transaction 1995-2021

In Romania, factoring knows a rapid evolution, as the Romanian Factoring Association (ASF) shows. In 10 years, the market tripled, if in 2011 the factoring volumes was 2.014.978 billion euros, in 2021 the Romanian market is over 6 billion euros. The profile of the companies who use factoring as financing tool is big companies with an annual turnover more than 50 million euro.

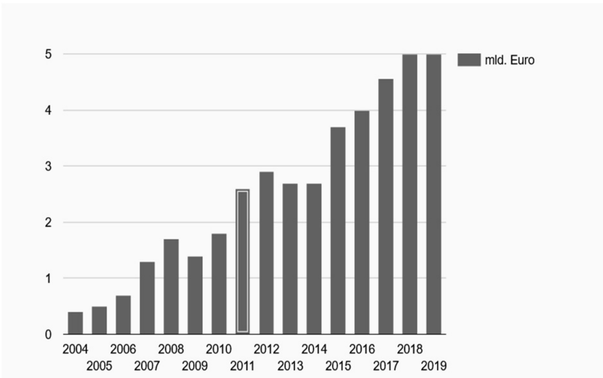

Figure 2. Factoring transaction in Romania

4 CASE STUDY

A company who sells products and has a 90 days policy for its clients wants to buy an equipment in order to increase the production and to complies with the EU regulation regarding the environmental protection. The cost of the equipment is 500.000 lei and has a depreciation period of 5 years (linear depreciation).

We will analyze this investment from the financing part, meaning that we assume that the investment is necessary and according to NPV, RIR is a profitable investment.

The financial manager, after analyzing the options, compared 3 solutions:

- Loan
- Financial leasing
- Mixt financing (companies funds 100.000 and factoring – accounts receivable 500.000)

The conditions for the loan are the following:

- Term – 5 years
- Interest – 9%
- Loan commission – 2% from the loan amount
- Insurance – 15.000/year

The terms for financial leasing:

- Advanced payment 10% from the acquisition amount of the equipment
- Leasing interest – 8,5%
- Leasing payment/year = 114.195
- Insurance – 15.000/year
- Management fee at the begging of the contract – 1,9%
- Bargain value at the end of the contract -10% (same amount as advanced payment)

Factoring terms:

- 80% accounts receivable financed
- Agio – 1%
- Financing commission – 10%

Supplementary information for the case study:

The amount of accounts receivable possible to be financed through factoring: 500.000 lei.

We analyze these options comparing the cost of the discounted payments.

The cost of the loan is obtained by making the sum of all 5 yearly discounted net payment and is **419.523** lei

The cost of the financial leasing is obtained by making the sum of all 5 yearly discounted net payment and is **457.413** lei

1. Loan						
	Year 0	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Payments		**139548**	**139548**	**139548**	**139548**	**139548**
Loan and interest		124548	124548	124548	124548	124548
Insurance		15000	15000	15000	15000	15000
Loan commission	10000					
Tax economies		**17120**	**15776**	**16032**	**13088**	**11360**
Interest *16%		6720	5376	5632	2688	960
Depreciation *16% (50000*16%)		8000	8000	8000	8000	8000
Insurance *16%		2400	2400	2400	2400	2400
Discounted rate		9.00%				
Net payment		122428	123772	123516	126460	128188
Discounted net payment		**112319**	**104176**	**95377**	**97650**	**83313**

2. Financial leasing						
	Year 0	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Payments		**111432**	**111432**	**111432**	**111432**	**161432**
Avans	50000					
Management fee	9500					
Leasing payment		96432	96432	96432	96432	96432
Insurance		15000	15000	15000	15000	15000

Bargain value at the end of leasing						50000
Tax savings		**17600**	**16000**	**15200**	**12800**	**12480**
Tax economies		7200	5600	4800	2400	2080
Interest *16% (50000*16%)		8000	8000	8000	8000	8000
Depreciation *16%		2400	2400	2400	2400	2400
Insurance *16%		10.50%				
Discounted rate		93832	95432	96232	98632	148952
Discounted net payment		**84916**	**78157**	**71324**	**73102**	**90414**

Cost of factoring
Nominal value of accepted invoices: 500000
Percentage of financied innvoices: 80%
Cash-flow received from factoring: 400000 eur
Factoring comission (agio) (1%): 5000 eur
Financing comission (10%) = 400000*10% = 40000 eur

Cost of factoring = 45000 eur

Cost of the mixt financing (factoring and self financing in terms of present value = 100.000 + 45.000 = **145.000 lei**

If we only take in consideration the cost of the financing alternative, than the solution to our financing problem is to accept the factoring solution and contribute to the rest of the amount with companie's liquidities.

5 CONCLUSION

The aim of this paper is to give a tool for the entrepreneurs when they have to decide between several sources of financing and to understand the differences and similarities of the proposed solutions.

The leasing and the factoring are long- or short-term solution for companies who have cash-flow problems and don't want or don't have access to traditional ways of financing.

The leasing and the factoring market are expected to grow in 2022 and this growth is explained mainly through the fact that businesses are trying to redesign their current operation and to recuperate from COVID-19. Companies faced social distancing, remote working and lack of liquidities so they were forced to change their way of acting, including in the financing area. Solutions like operational leasing were taken into consideration in order to save money from investment and to redirected them to operational costs.

Big amounts of fixed assets were a problem in the pandemic years so renting equipment or location was a solution for decreasing risks.

The COVID-19 years affected the way companies paid their debts, the payment term for accounts receivable increased, which put pressure either to increase their DPO (Days Payable Outstanding) or use factoring as a solution to solve short term cash-flow problems.

A form of factoring that has been used with success is reversed factoring, a special form of factoring not treated in this paper.

The paper presents a case study for only 3 types of financing and this limits the comparation to other alternatives. The solution proposed is not the best way for a company to finance their investments, that depends on its current financial situation, financing alternative´s accessibility, risk management, capital structure etc.

The study case can be developed by taking into considerations other alternatives like reverse factoring, non-refundable founds and also by introducing more restrictions/hypothesis when analyzing the financing decision like optimal WACC, increasing the financial leverage, a targeted profit margin or ROI.

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